

## Q&A with Gerald Stack

Gerald Stack, Head of Investments and Head of Infrastructure, talks about government plans to invest in infrastructure, how travel is faring under the pandemic, the risk of inflation, and what the new US president could mean for the portfolio's US utility and infrastructure stocks.

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**Q: To combat the economic damage of the pandemic, many countries have plans to spend money on infrastructure. But history shows that governments have a poor record of making these projects happen. Will this time be different?**

**A:** It's encouraging that governments want to spend money on infrastructure and such spending, if it were to eventuate, would certainly lead to some opportunities. Some of these planned projects are capital intensive and involve a lot of planning. They can take more than a decade from start to finish but they usually get done, even if governments can disappoint in terms of their timetables. We certainly expect to see some opportunities.

What is the nature of those opportunities? Broadly speaking, infrastructure projects fall into two camps; greenfield and brownfield developments.

Greenfield developments are projects that are new. A new airport in western Sydney would be an example, as would be new toll roads or new powerlines. Greenfield asset projects typically inspire competitive bids. You'll find unlisted infrastructure funds, pension funds, construction companies and listed infrastructure companies bidding for those projects. But investors need to be cautious because in many cases the underlying demand for the new service is uncertain. So greenfield projects carry a level of risk.

A brownfield development is where an existing asset or infrastructure service is being enhanced or expanded. As the asset already functions as a business, there are fewer unknowns in terms of demand and the way the business operates. The existing owner has an understanding of the business issues and, accordingly, brownfield projects are normally lower risk than greenfield projects. That's why we prefer to invest in brownfield opportunities. So to us the talk of new infrastructure investments is especially encouraging when it comes to brownfield developments.

**Q: The covid-19 blow to global travel shows no sign of ending soon. How do you view transportation stocks?**

**A:** Essentially, we want to invest in assets that provide services that are essential for the efficient functioning of communities such as airports and toll roads that transport people and goods. As they are essential, we don't think the drop in demand in the short term will last. Clearly, government restrictions on the movement of people and goods have slashed traffic on toll roads and passenger movements at airports. But we've seen already that, as health conditions improve, economies reopen and life trends back to what we would consider to be normal.

With airports, the worst month of 2020 was April when the number of aviation passengers globally was estimated to have plunged about 94% from a year earlier. Now, we're still in the midst of the pandemic and quarantine measures are still in place. We haven't seen a return to normal levels of traffic but we witnessed a progressive improvement in aviation numbers until December when passenger numbers were down 70% from a year earlier. That's still a big drop but it's an improvement.

There are basically three reasons why people fly: for leisure, to visit family and friends, and for business. Indications are that people are keen to go on holidays and visit friends and relatives but that business travel will take time to recover due to cost-cutting and the move to internet-based video conferencing such as Zoom and Microsoft Teams. Business travel might not approach previous peaks for a while yet. Another consideration is the length of any journey. We would expect shorter flights (domestic and regional trips) to bounce back while long haul could take much longer to recover.

Thus when it comes to airports we are looking at which ones handled a greater percentage of leisure and social travel and shorter flights. It could take until 2023 or 2024 for aviation numbers to return to 2019 levels but some airports will recover faster than others.

When it comes to toll roads, there are two types. There are inter-urban roads – roads that connect towns and cities – and urban roads – roads that exist within an urban area. Both types are enjoying a revival. Take the Italian motorway company Atlantia as an example. It owns inter-urban roads in France, Italy and Spain. In April, passenger numbers on Atlantia's inter-urban road networks plunged 80% to 85% from a year earlier. Yet over the European summer passenger traffic rebounded to approach within five percentage points of 2019 levels. This gives a sense of how when health outcomes improve and the economies reopen, traffic numbers rebound. We saw a similar pattern with the urban roads owned and operated by Australian toll-road operator Transurban, where traffic numbers declined by 50% to 55% in the initial phase of the pandemic before rebounding as health outcomes improved and government-imposed lockdowns eased. This pattern of traffic declines followed by a rebound was revisited during the subsequent waves of the pandemic.

### **Q: Turning to interest rates and inflation: while rates remain at record low levels, there is always the possibility they too will rise. How are you handling this risk?**

**A:** Let's think about inflation in terms of its effect on utilities and infrastructure and then the risks associated with that.

Utilities are regulated at the point of earnings. That is, the regulator sets the price of a service such that the utility earns a fair return. When inflation lifts running costs and the cost of capital, regulators allow utilities to raise their prices so that their returns remain appropriate over time. In other words, increases and decreases in inflation and interest rates have limited influence on the financial returns of regulated utilities.

The same goes for most infrastructure assets. Infrastructure assets typically are regulated at the point of the prices they can charge and these prices are typically linked to inflation. So the value of the business is somewhat protected from changes in inflation. Indeed, we expect inflation to boost the value of infrastructure assets over time, mainly because these assets typically enjoy higher patronage as populations and wealth grow.

An added risk with inflation is how central banks react to rising consumer prices. What would concern us most would be rapid and large increases in underlying interest rates to tame any flareup in inflation. Our first concern would be how an increase in the cost of debt could challenge companies. As it happens, the bulk of infrastructure companies around the world have used the low rates of recent times to lock in as much of their debt as possible for as long as possible at low rates. So, while a rise in interest rates would boost debt costs, companies have typically protected themselves with these steps. The other concern is that an increase in interest rates would diminish the present value of future cash flows, which could undermine share values.

### **Q: We have seen a change in US leadership. Does this mean anything for the stocks in your portfolio?**

**A:** There are probably two broad areas of policy focus we would expect from the administration of President Joe Biden. One is the transition to a low-carbon economy. The other is a tendency for higher taxes. Given that the numbers in the Senate are finely balanced, we don't expect extreme changes to policy but we do expect some changes.

There are three types of companies in which we can invest in the US infrastructure world. These are regulated utilities, freight rail and communications. When it comes to a transition to a low-carbon economy, we expect

tax and other incentives to encourage projects that are designed to enhance the effectiveness and efficiency of the electricity and energy networks. We would expect electricity utilities to be well placed in relation to these types of initiatives. The additional renewable energy will need to be connected to the grid and the existing electricity utilities will need to do that. That will lead to additional capital investment in their projects and a broader 'rate base' on which to earn a return. As for tax, utilities essentially pass through the higher charge to their customers. The same goes for communications companies because they are typically held in tax-pass-through trusts. Rail companies will bear any higher tax rates but they are expected to benefit from the administration's fiscal stimulus.

**Q: Finally, can you talk through the portfolio's relative performance in recent months and whether or not it is still on track to deliver on its objectives?**

**A:** We have underperformed in recent months. Over this time, the vaccine was announced and investment markets reacted strongly to the US election result. That led to a surge in some stocks that were punished earlier in the year when the pandemic hit. We have a conservative definition of infrastructure and we have reduced exposure to airports and other covid-19-exposed stocks in our universe. This means that we underperformed when news of a vaccine boosted these stocks. Are the companies we are holding performing poorly? No, we're happy with the underlying performance of these companies. We think the portfolio will deliver inflation plus 5% over the long term. While in any given year we might do better or worse than that, we have no reason to believe that the underlying investment thesis for any of these companies is broken. Clearly, there's been some volatility and there have been some economic shocks during the year, but the long-term business models for these companies look attractive to us, albeit that there are certainly some heightened levels of risk when it comes to assets such as airports.

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